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# Existence of an Equilibrium in a Competitive Economy with Indivisibilities and Money<sup>1</sup>

Gerard van der Laan<sup>2</sup>, Dolf Talman<sup>3</sup> and Zaifu Yang<sup>4</sup>

*Abstract* In this paper we introduce a model of an exchange economy with indivisible goods and money. There are finitely many agents each of whom owns one unit of each of finitely many different types of indivisible goods and certain amount of money. Each type of indivisible good is subject to quality differentiation. We demonstrate that under fairly mild conditions on demand the economy has a price equilibrium. The proof is based on a generalization of the well-known lemma of Knaster, Kuratowski and Mazurkiewicz (KKM) in combinatorial topology. The results in the paper generalize those of Gale in case of just one indivisible good present in the economy.

*Keywords:* Indivisibilities, equilibria, combinatorial lemmas.

## 1 Introduction

Since the publication of the seminal article of Gale and Shapley (1962) economic models with one indivisible good have been intensively studied by a lot of re-

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searchers, e.g., Shapley and Shubik (1972), Shapley and Scarf (1974), Kelso and Crawford (1982), Kaneko (1982), Quinzii (1984), Gale (1984), Kaneko and Yamamoto (1986), and Yamamoto (1987). Gale and Shapley (1962) considered a marriage market with two types of agents: men and women. Each man has preferences over women and each woman has preferences over men. Gale and Shapley studied this market from a game-theoretic point of view and demonstrated that there exists a stable matching. This model was generalized by Kelso and Crawford (1982) as a job matching model by allowing the presence of money. In the models presented by Shapley and Shubik (1972) and Kaneko (1982), there are two types of agents: sellers and buyers, and an indivisible good is traded for money. These models are asymmetric in the sense that sellers and buyers play completely different roles. Shapley and Scarf (1974) gave a similar but symmetric model, in which agents exchange their indivisible good without using money. Quinzii (1984) proposed a symmetric model which permits the presence of money and unifies the models above. She proved that the associated cooperative game has a nonempty core and that the associated market has a competitive equilibrium under several conditions on the utility functions of the agents. Gale (1984) made assumptions directly on demands instead of on the utility functions and proposed an elegant proof of the existence of a competitive equilibrium. The proof is based on an intersection lemma, which is a generalization of the KKM lemma. Kaneko and Yamamoto (1986) considered an asymmetric model in which sellers and buyers trade one indivisible good for money. They proved the existence of a competitive equilibrium by using a fixed point argument. In Yamamoto (1987) the model of Kaneko and Yamamoto is extended by allowing agents initially to own more than one unit of an indivisible good and making no difference among sellers and buyers. He showed by means of an ingenious argument that the market has a competitive equilibrium under some conditions on the utility functions of the agents. The crucial assump-

tion of all these models is that there is only one indivisible good and each agent demands no more than one unit of the indivisible good. Typically, we may think of the indivisible good as houses which all have the same function for agents but may be different in quality.

Until now, little progress has been made in dealing with economic equilibrium models with more than one type of indivisible good. Curiel and Tijs (1985) made a step forward by studying two classes of transferable utility games, namely, assignment games and permutation games in which there are two types of indivisible goods. They showed that these games may have an empty core but they proved that these games have a nonempty core in case of additivity and separability. In this paper we consider an economy in which there are a finite number of agents and a finite number of different types of indivisible goods. We may think of these different types of indivisible goods as houses, cars, trucks, bikes, and so on. Units of each type of indivisible good are subject to quality differentiation. For example, houses belong to one type of indivisible good and have the same function for agents but may be different in quality. Each agent initially owns at most one unit of each type of indivisible good and a certain amount of money. Agents have preferences over goods and money with the constraint that no agent desires more than one unit of each type of indivisible good. We impose rather plausible conditions on demand in order to guarantee the existence of a competitive equilibrium in the economy. The assumptions are similar to those as used by Gale (1984) in case of just one type of indivisible good. We only need boundedness and continuity. Our result also applies to a model with some kind of externalities<sup>5</sup> in the sense that whether or not an agent prefers a good of some type may depend on the prices of the other goods of that type or even on the prices of goods of other types. The proof of the existence of a competitive equilibrium in the economy is based on a generalization

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<sup>5</sup>Strictly speaking, this is not the definition of externalities. Here we follow an explanation of Gale (1984).

of the KKM lemma. The results we obtain in this paper generalize those of Gale and of Curiel and Tijs.

The rest of the paper is organized as follows. Section 2 presents the economic model. The proof of the equilibrium existence theorem is given in Section 3.

## 2 The economic model with indivisibilities and money

We shall consider an exchange economy with  $n$  agents and  $m$  different types of indivisible goods. Let  $I_k$  be the set of the first  $k$  positive integers. We denote the set of agents and the set of different types of indivisible goods by  $I_n$  and  $I_m$ , respectively. We assume that each agent initially owns one unit of each type of indivisible good and some amount of money. Notice that this involves no loss of generality since if some agent does not own one unit of some type of indivisible good we may assume that he has a dummy good of that type which is of no value to any of the agents. We denote that agent  $i$  owns one unit of indivisible good of type  $j$  by an ordering pair  $(j, i)$ . Let  $I_m \times I_n$  be the set of all indivisible goods in the economy, i.e.,  $I_m \times I_n = \{(j, i) \mid j \in I_m, i \in I_n\}$ . A price vector is a vector in  $\prod_{h=1}^m R_+^n$ , where  $R_+^n$  is the nonnegative orthant of the  $n$ -dimensional Euclidean space  $R^n$ . A vector  $p \in \prod_{h=1}^m R_+^n$  is represented by  $p = (p_1, \dots, p_m)$  where  $p_j = (p_{j1}, \dots, p_{jn})$  for each  $j \in I_m$ . Let  $\Phi = \{\rho \mid \rho = (\rho_1, \dots, \rho_n) \text{ is a permutation of } (1, \dots, n)\}$ . An element  $\pi \in \prod_{h=1}^m \Phi$  is written as  $\pi = (\pi_1, \dots, \pi_m)$  where  $\pi_j = (\pi_j(1), \dots, \pi_j(n))$  for each  $j \in I_m$ . Furthermore, for a positive integer  $k$ , let  $I_n^k$  denote  $I_n \times \dots \times I_n$  where  $I_n$  is repeated  $k$  times.

For each  $i \in I_n$  and each  $j \in I_m$ , the demand of agent  $i$  for the indivisible good of type  $j$  is specified by a covering  $C_i^j = \{C_i^{(j,0)}, C_i^{(j,1)}, \dots, C_i^{(j,n)}\}$  of  $\prod_{h=1}^m R_+^n$ . Let us give some explanation. If  $p \in C_i^{(j,k)}$ , this implies that at price  $p$  for agent  $i$  there

is no good of type  $j$  owned by any other agent rather than agent  $k$  to which he prefers strictly. If  $p \in C_i^{(j,0)}$ , this means that at price  $p$  for agent  $i$  there is no good of type  $j$  he prefers above exchanging his good of type  $j$  for money.

**Definition 2.1** *A pair of vectors  $(p, \pi) \in \prod_{h=1}^m R_+^n \times \prod_{h=1}^m \Phi$  is a competitive equilibrium if it holds that  $p \in C_i^{(j, \pi_j(i))}$  for all  $j \in I_m$  and all  $i \in I_n$ .*

From the definition, at an equilibrium each agent obtains one unit of each type of indivisible good and there are no other goods he prefers strictly. Let  $B^n$  denote the boundary of  $R_+^n$ . Now we make the following assumptions on the demands:

- (A1) The set  $C_i^{(j,l)}$  is closed for any  $j \in I_m$ ,  $i \in I_n$  and  $l \in I_n \cup \{0\}$ ;
- (A2) For each  $i \in I_n$  and each  $j \in I_m$ ,  $C_i^{(j,1)}, \dots, C_i^{(j,n)}$  cover  $\prod_{h=1}^m B^n$ ;
- (A3) There exists  $M > 0$  such that if  $p_{jl} \geq M$ , then  $p \notin C_k^{(j,l)}$  for all  $k \in I_n$ .

Assumption (A1) says that every agent has a positive amount of money and that no agent would give up all of his money to buy any good. Assumption (A2) says that if a price of a good of some type is zero, then every agent demands some good of that type. Finally Assumption (A3) implies that no agent is willing to spend a huge amount of money on any good. It should be noted that the above assumptions are identical to those of Gale (1984) in case of just one type of indivisible good, i.e.,  $m = 1$ .

Now we are ready to state the equilibrium theorem.

**Theorem 2.2** *Under Assumptions (A1), (A2) and (A3), the economy has at least one competitive equilibrium  $(p, \pi) \in \prod_{h=1}^m B^n \times \prod_{h=1}^m \Phi$ .*

### 3 The proof of the existence of an equilibrium

We first introduce some notation. The vector  $e(i)$  is the  $i$ -th unit vector of  $R^n$  for each  $i \in I_n$ . The vector  $e$  denotes a vector in  $R^n$  all of whose components equal 1.

For each  $i \in I_n$ , let  $a^i$  denote the vector  $e/n - e(i)$  in  $R^n$ . In order to prove the equilibrium theorem, we first generalize the KKM lemma. The  $(n-1)$ -dimensional unit simplex  $S^n$  is defined by

$$S^n = \{x \in R_+^n \mid \sum_{i=1}^n x_i = 1\}.$$

Let  $\mathcal{S}$  denote the simplotope  $\prod_{h=1}^m S^n$ .

**Theorem 3.1** *For each  $i \in I_n$  and each  $j \in I_m$ , let the collection of closed sets  $\{C_i^{(j,1)}, \dots, C_i^{(j,n)}\}$  be a covering of the simplotope  $\mathcal{S}$  such that if  $p$  lies on the boundary of  $\mathcal{S}$  then for some  $k \in I_n$  it holds that  $p \in C_i^{(j,k)}$  and  $p_{jk} > 0$ . Then there exist  $\pi \in \prod_{h=1}^m \Phi$  and  $p^* \in \mathcal{S}$  such that*

$$p^* \in \cap_{j=1}^m \cap_{i=1}^n C_i^{(j, \pi_j(i))}.$$

Proof: For each  $i \in I_n$ , we define

$$C_i^{(i_1, \dots, i_m)} = \cap_{j=1}^m C_i^{(j, i_j)}.$$

Clearly,  $C_i^{(i_1, \dots, i_m)}$  is a closed set, and the collection of sets  $\{C_i^T \mid T \in I_n^m\}$  is a covering of  $\mathcal{S}$ . Furthermore, it is not difficult to show that if  $p$  lies on the boundary of  $\mathcal{S}$  then for some  $T = (i_1, \dots, i_m) \in I_n^m$  it holds that  $p \in C_i^T$  and  $p_{ji_j} > 0$  for every  $j \in I_m$ . Now let  $\bar{\mathcal{S}}$  denote the set  $\mathcal{S} \times S^n$ . For each  $(i_1, \dots, i_{m+1}) \in I_n^{m+1}$ , define

$$C^{(i_1, \dots, i_{m+1})} = C_{i_{m+1}}^{(i_1, \dots, i_m)} \times S^n.$$

Clearly,  $C^{(i_1, \dots, i_{m+1})}$  is a closed set, and the collection of sets  $\{C^T \mid T \in I_n^{m+1}\}$  is a covering of  $\bar{\mathcal{S}}$ . If  $p$  lies on the boundary of  $\bar{\mathcal{S}}$  then for some  $T = (i_1, \dots, i_{m+1}) \in I_n^{m+1}$  it holds that  $p \in C^T$  and  $p_{ji_j} > 0$  for every  $j \in I_{m+1}$ .

For each  $(i_1, \dots, i_{m+1}) \in I_n^{m+1}$ , define a vector  $c^{(i_1, \dots, i_{m+1})} \in \prod_{h=1}^{m+1} R^n$  by

$$c^{(i_1, \dots, i_{m+1})} = (a^{i_1}, \dots, a^{i_{m+1}}).$$

Let the set  $V = \prod_{h=1}^{m+1} V^h$  be given by for  $h = 1, \dots, m+1$ ,

$$V^h = \{x_h \in R^n \mid \sum_{j=1}^n x_{hj} = 1, x_{hj} \geq -1/n \text{ for every } j \in I_n\}.$$

For  $x \in V$  the point  $p(x)$  is defined as the projection of  $x$  on  $\bar{\mathcal{S}}$ , i.e.,  $p(x) = (p_1(x), \dots, p_{m+1}(x))$  with the projection  $p_h(x)$  of  $x_h$  in  $V^h$  on  $S^n$  given by

$$p_{hj}(x) = \begin{cases} 0 & \text{if } x_{hj} < 0 \\ x_{hj} / \sum_{\{l \mid x_{hl} \geq 0\}} x_{hl} & \text{if } x_{hj} \geq 0. \end{cases}$$

Now let the point-to-set mapping  $F$  from  $V$  to the collection of subsets of  $\prod_{h=1}^{m+1} R^n$  be given by

$$F(x) = \text{Conv}(\{c^{(i_1, \dots, i_{m+1})} \mid p(x) \in C^{(i_1, \dots, i_{m+1})} \text{ and } x_{ji_j} \geq 0 \text{ for every } j \in I_{m+1}\}),$$

where  $\text{Conv}(D)$  denotes the convex hull of a set  $D$ . It is easy to see that  $F$  is upper semi-continuous. Moreover,  $\cup_{x \in V} F(x)$  is compact, and for each  $x \in V$  the set  $F(x)$  is nonempty, convex and compact. Let  $Y$  be a compact, convex set in  $\prod_{h=1}^{m+1} R^n$  containing  $\cup_{x \in V} F(x)$ . Then we define the point-to-set mapping  $G$  from  $Y$  to the collection of subsets of  $V$  by

$$G(y) = \{x^* \in V \mid x_h^\top y_h \leq (x_h^*)^\top y_h \text{ for all } x_h \in V^h \text{ and } h \in I_{m+1}\}.$$

Again,  $G$  is upper semi-continuous. Moreover, for any  $y \in Y$  the set  $G(y)$  is nonempty, compact and convex and  $\cup_{y \in Y} G(y)$  is bounded. For  $(x, y) \in V \times Y$ , let  $\phi(x, y)$  be defined as

$$\phi(x, y) = G(y) \times F(x),$$

then  $\phi$  is an upper semi-continuous mapping from the set  $V \times Y$  into the collection of nonempty subsets of  $V \times Y$  satisfying for every  $(x, y) \in V \times Y$  that the set  $\phi(x, y)$  is nonempty, convex and compact. According to Kakutani's fixed point theorem, there exists an  $(x^*, y^*) \in V \times Y$  such that

$$x^* \in G(y^*) \text{ and } y^* \in F(x^*).$$



So it holds that

$$x_h^\top y_h^* \leq (x_h^*)^\top y_h^*$$

for every  $x_h \in V^h$  and  $h \in I_{m+1}$ . Let  $\beta_h$  be equal to  $(x_h^*)^\top y_h^*$ . Then by taking  $x_h$  equal to  $\epsilon/n$ , it follows that  $\beta_h \geq 0$ , since  $\sum_{j=1}^n y_{hj}^* = 0$  for any  $h \in I_{m+1}$ . When we take  $x_h$  successively equal to  $\epsilon(j)$  for every  $j \in I_n$ , we obtain

$$y_{hj}^* \leq \beta_h, \text{ for every } h \in I_{m+1} \text{ and } j \in I_n.$$

On the other hand, if for some  $h \in I_{m+1}$  and  $j \in I_n$  it holds that  $x_{hj}^* > -1/n$ , by taking  $x_h$  equal to  $x_h^* + \lambda(x_h^* - \epsilon(j))$  for arbitrarily small  $\lambda > 0$ , we obtain that  $y_{hj}^* \geq \beta_h$ . Hence  $y_{hj}^* = \beta_h \geq 0$  when  $x_{hj}^* > -1/n$ .

Let the collection  $\mathcal{T}^*$  of elements of  $I_n^{m+1}$  be defined by

$$\mathcal{T}^* = \{T = (i_1, \dots, i_{m+1}) \in I_n^{m+1} \mid p(x^*) \in C^T \text{ and } x_{ji_j}^* \geq 0 \text{ for every } j \in I_{m+1}\}.$$

Suppose that  $\mathcal{T}^* = \{T^1, \dots, T^l\}$ , where  $T^k = (i_1^k, \dots, i_{m+1}^k)$ . Since  $y^* \in F(x^*)$  there exist some nonnegative numbers  $\mu_1, \dots, \mu_l$  with sum equal to 1 such that

$$y^* = \sum_{k=1}^l \mu_k c^{T^k}.$$

Suppose that  $x_{hj}^* = -1/n$  for some  $h \in I_{m+1}$  and  $j \in I_n$ . Then it implies that  $j \neq i_h^k$  for every  $k = 1, \dots, l$  and hence  $y_{hj}^* \geq 0$ . Since  $\sum_{j=1}^n y_{hj}^* = 0$  for any  $h \in I_{m+1}$ , we have that  $y^* = \mathbf{0}$ . So,

$$\sum_{k=1}^l \mu_k c^{T^k} = \mathbf{0}. \quad (3.1)$$

Now for each  $k \in I_m$ , define

$$S_k = \{(i_k^h, i_{m+1}^h) \mid h = 1, \dots, l\}.$$

It is clear that  $S_k$  is a subset of  $I_n \times I_n$ . It follows from (3.1) that for every  $k \in I_m$

$$\sum_{(i,j) \in S_k} \mu_{(i,j)}^k (a^i, a^j) = \mathbf{0}$$

and that

$$\sum_{(i,j) \in S_k} \mu_{(i,j)}^k = 1$$

for certain  $\mu_{(i,j)}^k \geq 0$  for  $(i,j) \in S_k$ . Moreover, it holds that for each  $i \in I_n$ ,  $\sum_j \mu_{(i,j)}^k = 1/n$  and that for each  $j \in I_n$ ,  $\sum_i \mu_{(i,j)}^k = 1/n$ . From this property it follows that the  $n \times n$  matrix  $U(k)$  with entries  $\nu_{(i,j)}^k$  defined by  $\nu_{(i,j)}^k = n\mu_{(i,j)}^k$  if  $(i,j) \in S_k$  and  $\nu_{(i,j)}^k = 0$  if  $(i,j) \notin S_k$  is a doubly stochastic matrix and therefore  $U(k)$  is a convex combination of permutation matrices according to the theorem of Birkhoff and von Neumann. So, there exists a permutation  $\pi_k = (\pi_k(1), \dots, \pi_k(n))$  of  $(1, \dots, n)$  such that  $\nu_{(\pi_k(j), j)}^k > 0$  and hence  $(\pi_k(j), j) \in S_k$  for every  $j \in I_n$ . Since  $p(x^*) \in \cap_{h=1}^l C^{T^h}$ , it implies that

$$\cap_{k=1}^m \cap_{j=1}^n C_j^{(i_1^j(k), \dots, i_{k-1}^j(k), \pi_k(j), i_{k+1}^j(k), \dots, i_m^j(k))} \neq \emptyset,$$

where  $(i_1^j(k), \dots, i_{k-1}^j(k), \pi_k(j), i_{k+1}^j(k), \dots, i_m^j(k), j) \in \mathcal{T}^*$  for every  $k \in I_m$  and  $j \in I_n$ . For each  $i \in I_n$ , since

$$C_i^{(\pi_1(i), \dots, \pi_m(i))} = \cap_{j=1}^m C_i^{(j, \pi_j(i))}$$

we obtain that

$$\cap_{j=1}^m \cap_{i=1}^n C_i^{(j, \pi_j(i))} \neq \emptyset.$$

This completes the proof.  $\square$

We note that the intersection lemma of Gale (1984) follows from Theorem 3.1 by setting  $m = 1$ . The intersection lemma of Gale implies the KKM lemma. Now we are ready to derive Theorem 2.2.

Proof of Theorem 2.2: Without loss of generality, we take  $M = 1$  for Assumption (A3). Let  $A^n$  be the intersection of  $B^n$  and the unit  $n$ -cube  $U^n$ . We shall construct a homeomorphism  $\psi$  from  $\prod_{h=1}^m A^n$  into  $\mathcal{S}$  such that for each  $j \in I_m$

and  $i \in I_n$ , the collection  $\{\psi(C_i^{(j,k)}) \mid k \in I_n\}$  is a covering of  $\mathcal{S}$  satisfying the boundary condition of Theorem 3.1. Then the result immediately follows from Theorem 3.1. For  $p = (p_1, \dots, p_m) \in \prod_{h=1}^m A^n$  the point  $\psi(p)$  is defined as  $\psi(p) = (\psi_1(p_1), \dots, \psi_m(p_m))$  where  $\psi_h$  is a homeomorphism from  $A^n$  into  $S^n$  for each  $h \in I_m$ . For each  $h \in I_m$ , the mapping  $\psi_h$  is constructed as follows. For each permutation  $\rho = (i_1, i_2, \dots, i_n)$  of  $(1, \dots, n)$  we define a subset  $A^\rho$  of  $A^n$  by

$$A^\rho = \{p_h \in A^n \mid p_{h,i_1} \geq p_{h,i_2} \geq \dots \geq p_{h,i_n} = 0\}$$

and define a subset  $S^\rho$  of  $S^n$  by

$$S^\rho = \{x_h \in S^n \mid x_{hi_1} \leq x_{hi_2} \leq \dots \leq x_{hi_n}\}.$$

We then define  $\psi_h$  from  $A^\rho$  to  $S^\rho$  by

$$(\psi_h(p_h))_{hi_1} = x_{hi_1} = \frac{1 - p_{hi_1}}{n},$$

and

$$(\psi_h(p_h))_{hi_k} = x_{hi_k} = \frac{1 - p_{hi_1}}{n} + \frac{p_{hi_1} - p_{hi_2}}{n-1} + \dots + \frac{p_{hi_{k-1}} - p_{hi_k}}{n-k+1},$$

for  $k \in I_n \setminus \{1\}$ . It is easy to see that  $\sum_{k=1}^n (\psi_h(p_h))_{hi_k} = 1$ , and  $(\psi_h(p_h))_{hi_k} \geq 0$  for any  $k$ . Moreover,  $p_h \neq p'_h$  implies  $\psi_h(p_h) \neq \psi_h(p'_h)$ . Now take  $x_h \in S^\rho$ . We have

$$x_{hi_1} \leq x_{hi_2} \leq \dots \leq x_{hi_n}.$$

Notice that we have

$$p_{hi_1} = 1 - nx_{hi_1}$$

and

$$p_{hi_k} = p_{hi_{k-1}} - (n-k+1)(x_{hi_k} - x_{hi_{k-1}}),$$

for  $k \in I_n \setminus \{1\}$ . It follows that  $p_h \in A^\rho$ . Observe that  $\psi_h^{-1}(e(j)) = e - e(j)$  and

$$\psi_h^{-1}(\{x_h \in S^n \mid x_{hj} = 0\}) = \{p_h \in A^n \mid p_{hj} = 1\}.$$

By Assumption (A3)  $C_i^{(j,k)}$  does not meet  $\psi^{-1}(\{x \in \mathcal{S} \mid x_{jk} = 0\})$ . This implies that  $\psi(C_i^{(j,k)})$  does not meet  $\{x \in \mathcal{S} \mid x_{jk} = 0\}$  for any  $i \in I_n$ ,  $j \in I_m$ , and  $k \in I_n$ . Hence it follows that if  $x$  is on the boundary of  $\mathcal{S}$  then for some  $k \in I_n$  it holds that  $x \in \psi(C_i^{(j,k)})$  and  $x_{jk} > 0$ . So, the boundary condition of Theorem 3.1 is fulfilled. We obtain the equilibrium theorem.  $\square$

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